

Message Text

CONFIDENTIAL

PAGE 01 ADDIS 09722 01 OF 02 200956Z

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ACTION SS-25

INFO OCT-01 ISO-00 SSO-00 /026 W

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R 200523Z AUG 76

FM AMEMBASSY ADDIS ABABA

TO SECSTATE WASHDC 632

CONFIDENTIAL SECTION 1 OF 2 ADDIS ABABA 9722

EXDIS

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E.O. 11652: GDS

TAGS: ECON EAID EFIN MASS MPOL ET US

SUBJECT: UPDATE OF PROJECTED EPMG MILITARY PROCUREMENT AND ITS
ECONOMIC IMPACT

REF: ADDIS ABABA 3304 AND PREVIOUS

1. SUMMARY

A. EMBASSY/USMAAG RECENTLY COMPLETED THE SEMI-ANNUAL UPDATE OF OUR ASSESSMENT OF EPM'S APPARENT INTENTIONS REGARDING PURCHASE OF MILITARY GOODS AND SERVICES FROM U.S. AND THIRD COUNTRY SOURCES. COMPARED TO OUR PREVIOUS ESTIMATE (FEBRUARY 1976), THE PROJECTED LEVEL OF PROCUREMENT HAS DECLINED BY ABOUT US \$78 MILLION -- FROM \$394.2 MILLION TO \$315.8 MILLION. THE DECLINE STEMS FROM PROCUREMENT OF FEWER AIRCRAFT, LESS SOPHISTI-CATED COMMAND AND CONTROL SYSTEMS AND A LOWER LEVEL OF O&M EXPENDITURE.

B. AS ETHIOPIA'S FOREIGN EXCHANGE RESERVE POSITION REMAINS VARY STRONG AND ITS BALANCE OF PAYMENTS OUTLOOK IS REASONABLY GOOD, WE BELIEVE THAT THE PROJECTED LEVEL OF PROCUREMENT WILL NOT PLACE UNDUE PRESSURE ON ETHIOPIA'S EXTERNAL POSITION FOR THE NEXT TWO YEARS NOR WILL IT NECESSARILY COMPETE WITH DEVELOPMENT PROGRAMS FOR FOREIGN EXHANGE. FRON THE STADPOINT OF THE BUDGET, IT APPEARS THAT THE INCREASING EXPENDITURES FOR MILITARY PERSONNEL AND OTHERLOCAL DEFENSE COSTS MAY ACCOUNT FOR THE REDUCTION IN

CONFIDENTIAL

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PAGE 02 ADDIS 09722 01 OF 02 200956Z

THE PROJECTED LEVELS OF OFF-SHORE MILITARY PROCURMENT. END SUMMARY

2. THE EMBASSY AND US MAAG HAVE COMPLETED OUR SEMI-ANNUAL UPDATE OF OUR ASSESSMENT OF THE EPMG'S APPARENT INTENTIONS REGARDING PURCHASE OF MILITARY GOODS AND SERVICES FROM THE US AS WELL AS OTHER SOURCES. AS BEFORE, OUR ESTIMATES OF PROJECTED OUTLAYS ARE IN CURRENT (QOY) US DOLLARS AND ENCOMPASS THE NEXT FIVE YEARS. THE ESTIMATES INCLUDE CAPITAL, O&M, SPARE PARTS, AND INTEREST COSTS. THE SAME ASSUMPTIONS AND CAVEATS WHICH APPLIED TO PREVIOUS ASSESSMENTS ALSO APPLY TO THIS ONE WITH THE EXCEPTION OF OGM OUTLAYS WHICH HAVE BEEN REDUCED ON THE GROUNDS THAT THE EPMG WILL NOT ADHERE TO US OPERATIONS AND TRAINING STANDARDS, IN CONTRAST TO OUR PREVIOUS ASSUMPTION.

MILITARY PROCUREMENT -CASH OUTLAY (US \$ MILLION)

US FISCAL YEAR

FY 76 FY 75/77 FY 78 FY 79 FY 80 TOTAL

A. PREVIOUS EST (2/76)	50.2	89.5	112.6	67.8	74.1	394.2
CAPITAL INV.	46.0	75.5	112.6	67.8	74.1	394.2
O&M	4.2	14.0	25.1	34.8	49.1	127.2

B. CURRENT EST (8/76) 55.8 97.0 49.6 51.5 61.9 315.8

CAPITAL INV.	53.1	81.7	18.8	25.3	31.1	210.0
O&M	2.7	15.3	30.8	26.2	30.8	105.8

3. FOR THE FIRST TIME SINCE WE BEGAN COMPILEIN THESE PROJECTIONS, OUR PREVIOUS ESTIMATE IS HIGHER THAN OUR CURRENT ONE, THE DIFFERENCE BEING APPROXIMATELY \$78 MILLION, IT WILL BE NOTED, HOWEVER, THAT IN FY 76 (WHICH IS A PROVISIONAL FIGURE) AND FY 77/77, OUTLAYS HAVE INCREASED BY 10 PERCENT Owing TO A TRUCK BUY AND PROJECTED L-100 BUY (THREE AIRCRAFT). CAPITAL INVESTMENT HAS DECLINED IN THE LAST THREE YEARS OF THEPERIOD BECAUSE OFAPPARENT EPMG DECISIONS NOT BO BUY C-130S, A-37S, RF-5E AND CERTAIN COMMAND AND CONTROL SYSTEMS. O&M HAS DECLINED IN PART BECAUSE OF REDUCED CAPTIAL PROCUREMENT AND IN PART BECAUSE OF LOWER O&M ESTIMATES WHICH, WE BELIEVE, ARE MORE IN KEEPING WITH LIKELY EPMG BEHAVIOR. AN INCREASINGLY DIFFICULT ASPECT OF THE ASSESSMENT IS PROJECTING THE AMOUNT OF THIRD COUNTRY PROCUREMENT. ALTHOUGH WE HEAR NUMEROUS RUMORS CONCERNING PROPOSED EPMG PROCUREMENT FROM NON-US SOURCES, WE HAVE NOT BEEN

CONFIDENTIAL

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PAGE 03 ADDIS 09722 01 OF 02 200956Z

ABLE TO CONFIRM ANY SUBSTANTIAL TRANSACTIONS WITH THIRD COUNTRIES. MOREOVER, WERE SUCH TRANSACTIONS TO MATERIALIZE, WE ARE NOT CERTAIN WHETHER THEY WOULD BE IN PLACE OF US PROCUREMENT OR IN ADDITION TO IT. IT IS POSSIBLE, THEREFORE, THAT THESE ESTIMATES UNDERSTATE EPMG PROCUREMENT DURING THIS PERIOD.

4. EOCNOMIC IMPLICATIONS: TAKING FIRST THE FOREIGN EXHANGE IMPACT OF THIS LEVEL OF PROCUREMENT, IT APPEARS LIKELY THAT THE

EPMG WILL BE ABLE TO COPE WITH THEPROPOSED LEVELS OVER THE NEXT TWO YEARS WITHOUT SUFFERING UNDUE DISLOCATIONS. ETHIOPIA'S FOREIGN EXCHANGE POSITION CONTINUES TO BE EXTRAORDINARILY STRONG; NET FOREIGN EXCHANGE RESERVES WERE APPROXIMATELY US \$350 MILLION AS OF JUNE 30, 1976. GIVEN THIS LEVEL OF RESERVES, ADDITIONAL UNREPORTED GOLD HOLDINGS BY THE MINISTRY OF FINANCE REPUTED TO BE ON THE ORDER OF \$20 MILLION (AT CURRENT PRICES) AND REASONABLY GOOD PROSPECTS FOR ETHIOPIA'S EXTERNAL SECTOR, THE OUTLOOK FOR EHTIOPIA'S EXTERNAL POSITION IS QUITE GOOD. ON THEOTHERHAND, WITHIN THE RELATIVELY NEAR FUTURE THE EPMG WILL PROBABLY NEED TO USE AT LEAST SOME OF ITS RESERVES FOR INVESTMENT PURPOSES. IN ADDITION, INFLATIONARY PRESSURE SHOULD CONTINEU TO INCREASE DEMAND FOR SONSUMER IMPORTS. THERE IS ALSO THE QUESTION OF COMP-ENSATION FOR NATIONALIZED INDUSTRIES WHICH HAS STILL NOT BEEN RESOLVED BUT WILL PRESUMABLY REQUIRE SOME FOREIGN EXCHANGE OUTLAYS DURING THE NEXT FIVE YEARS. IN A NEW DEVELOPMENT (SINCE OUR LAST ASSESSMENT) IT APPEARS THAT THE EPMG IS SERIOUSLY CONSIDERING LESS RELIANCE ON WESTERN PUBLIC CAPITAL INFLOWS TO COVER ITS DEVELOPMENT PROGRAM. TO THE EXTENT THIS OCCURS AND IS NOT OFFSET BY INFLOWS FROM OTHER (SOCIALIST COUNTRY) SOURCES, ADDITIONAL PRESSURE WILL BE BROUGHT TO BEAR ON ETHIOPIA'S FOREIGN EXCHANGE POSITION. BUT THESE EFFECTS WILL PROBABLY NOT BECOME SEVERE FOR AT LEAST TWO YEARS.

5. THE IMPACT OF THE EPMG'S PROPOSED PROCUREMENT ON ETHIOPIA'S INTERNAL POSITION IS CLEARLY MORE SERIOUS AND IS PROBABLY THE REASON WHY THE EPMG HAS APPARENTLY SCALED DOWN ITS PROPOSED PROCUREMENT LEVELS. IN ADDITION TO OFFSHORE PROCUREMTN THE EPMG MUST ALSO COVER PERSONNEL AND OTHER LOCAL COSTS. THESE HAVE GONE UP SUBSTANTIALLY DURING THE PAST TWO YEARS. FOR EXAMPLE, WE ESTIMATE THAT THE NUMBER OF PERSONNEL SERVING IN THE GROUND FORCES AND TERRITRIAL ARMY HAS INCREASED BY 12 PER CENT SINCE CY 1976 (44,600 SLOTS IN CY 75 COMPARED TO 51,600 SLOTS IN CY 76).

CONFIDENTIAL

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PAGE 04 ADDIS 09722 01 OF 02 200956Z

MOST OF THIS INCREASE HAS OCCURRED IN THE LAST SIX MONTHS WITH THE NEW FLAME UNIT AND THE SO-CALLED FATHER FIGHTERS (VETERANS RECALLED TO SERVICE) INCREASING PERSONNEL STRENGTH BY SOME 7,000. ALSO, AROUND 4,600 TROOPS WERE TRANSFERRED IN CY 1975 FROM THE TERRITORIAL ARMY TO THE GROUND FORCES WHERE, PRESUMABLY, THEIR PAY AND BENEFITS INCREASED. IN ADDITION, THE INCREASED PACE OF CONFLICT IN ERITREA AND ELSWHERE IN ETHIOPIA HAS ALMOST CERTAINLY HAD AN IMPACT ON OUTLAYS. ACCCORING TO PUBLISHED MINSITRY OF FIANCE FIGURES, THE MINISTRY OF DEFENSE SPENT APPROXIMATELY ETH\$150 MILLION DURING THE FIRST SIX MONTHS OF FY 76. AS BOTH THE FATHER FIGHTERS AND THE FLAME UNIT WERE ESTABLISHED AFTER THE FIRST OF THE YEAR, OUTLAYS FOR THE SECOND SIX MONTHS OF FY 76 MUST BE EVEN HIGHER. MOREOVER, IT IS LIKELY THAT THESE FIGURES DO NOT INCLUDE THE ETH \$55 MILLION RAISED BY THE GOLD TRANSACTION PREVIOUSLY MENTIONED AS

NO LOCAL CURRENCY COUNTERPART WAS NEEDED FOR THOSE TRANSACTIONS. CONSEQUENTLY, IT SEEMS LIKELY THAT TOTAL MINISTRY OF DEFENSE EXPENDITURES (I.E., INCLUDING THE EXTRA BUDGETARY GOLD TRANSACTION) MAY WELL HAVE FALLEN IN THE ETH \$375-400 MILLION RANGE FOR FY 1976. GIVEN THESE LEVELS OF EXPENDITURES THE MINISTRY OF DEFENSE HAS PROBABLY COME UNDER GREAT PRESSURE FROM THE MINISTRY OF FINANCE AND POSSIBLY THE DIRG TT SCALE DOWN ITS SPENDING, TIENKEN

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PAGE 01 ADDIS 09722 02 OF 02 200928Z

11

ACTION SS-25

INFO OCT-01 ISO-00 SSO-00 /026 W
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TO SECSTATE WASHDC 633

CONFIDENTIAL SECTION 2 OF 2 ADDIS ABABA 9722

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ESPECIALLY FOR CAPITAL PROCUREMENT . IN THIS CONNECTION IT IS INTERESTING TO NOTE THAT GOVERNMENT DEFICIT FINANCE HAS LEVELED OFF OVER THE PAST THREE MONTHS AND THAT OUTLAYS FOR MAJOR DEVELOPMENT PROJECTS HAVE NOT YET MATERIALIZED.

6. THE DEFENSE BUDGET ALSO CONTRIBUTES TO INFLATIONARY PRESSURES THROUGH ITS INCREASED OUTLAYS FOR PERSONNEL EXPENSES BUT NOT FOR CAPITAL EXPENDITURES. AS EXPLAINED IN REFTELS, AS LONG AS ETHIOPIA'S FX POSITION IS STRONG AND NO RESTRICTIONS ARE PLACED ON IMPORTS, LOCAL DEMAND SHOULD BE TRANSLATED INTO INCREASED IMPORTS. THIS IS NOT HAPPENING TO THE EXTENT IT SHOULD, PROBABLY BECAUSE IMPORTERS ARE UNCERTAIN ABOUT THE POLITICAL FUTURE OF ETHIOPIA. CAPITAL PROCUREMENT OF DEFENSE GOODS, THEN, WILL NOT CONTRIBUTE TO INFLATION UNTIL CONSUMER AND INVESTMENT GOODS IMPORTS COMPETE WITH DEFENSE GOODS IMPORTS FOR THE SAME AMOUNT OF (LIMITED) FOREIGN EXCHANGE. THIS IS NOT LIKELY TO BE THE CASE FOR THE NEXT YEAR OR TWO.

4. CONCLUSIONS: WE CONCLUDE FROM THE FOREGOING THAT: (A) THE
REASON FOR THE REDUCTION IN PROPOSED OUTLAYS FOR MILITARY
PROCUREMENT IS PROBABLY MORE RELATED TO THE LOCAL CURRENCY COSTS
OF THE DEFENSE BUDGET IN GENERAL THAN TO CONCERN ABOUT USE OF
EXCHANGE FOR MILITARY PROCUREMENT; (B) THE LARGE INCREASE IN
DEFENSE EXPENDITURE
MAY HAVE FORCED A REDUCTION OR A DELAY IN DEVELOPMENT EXPENDITURE;
(C) OFF-SHORE MILITARY PROCUREMENT IS NOT CONTRIBUTING TO INFLATION
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PAGE 02 ADDIS 09722 02 OF 02 200928Z

BUT INCREASED SPENDING FOR PERSONNEL COSTS IS; AND (D) IT
APPEARS FROM THE REDUCED LEVEL OF PROJECTED OUTLAYS FOR
MILITARY PROCUREMENT AND FROM THE MINIMAL AMOUNT OF DEFICIT
FINANCE OVER THE PAST THREE MONTHS, THAT THE EPMG IS CONCERNED
ABOUT INFLATION AND OTHER ECONOMIC COSTS (I.E., LESS DEVELOPMENT
EXPENDITURE) RELATED TO AN INCREASING DEFENSE BUDGET.

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